DOW THEORY LETTERS INC.

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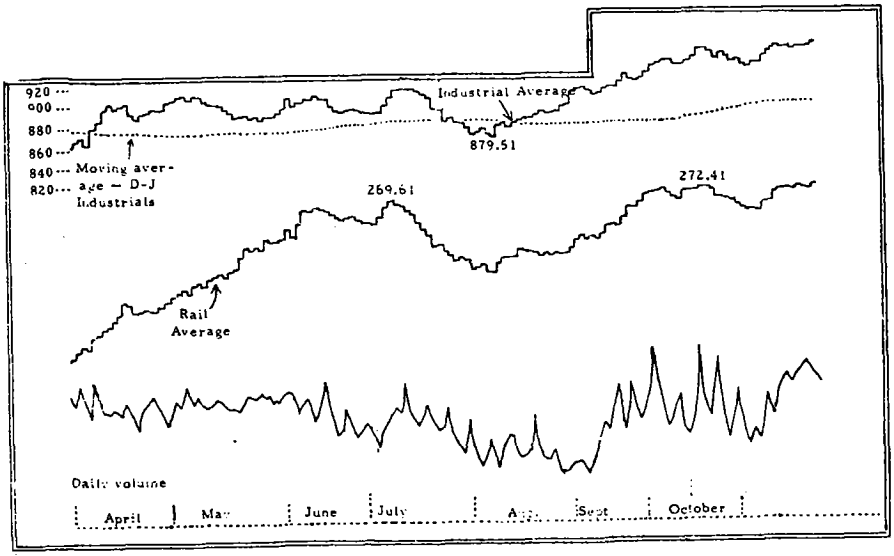
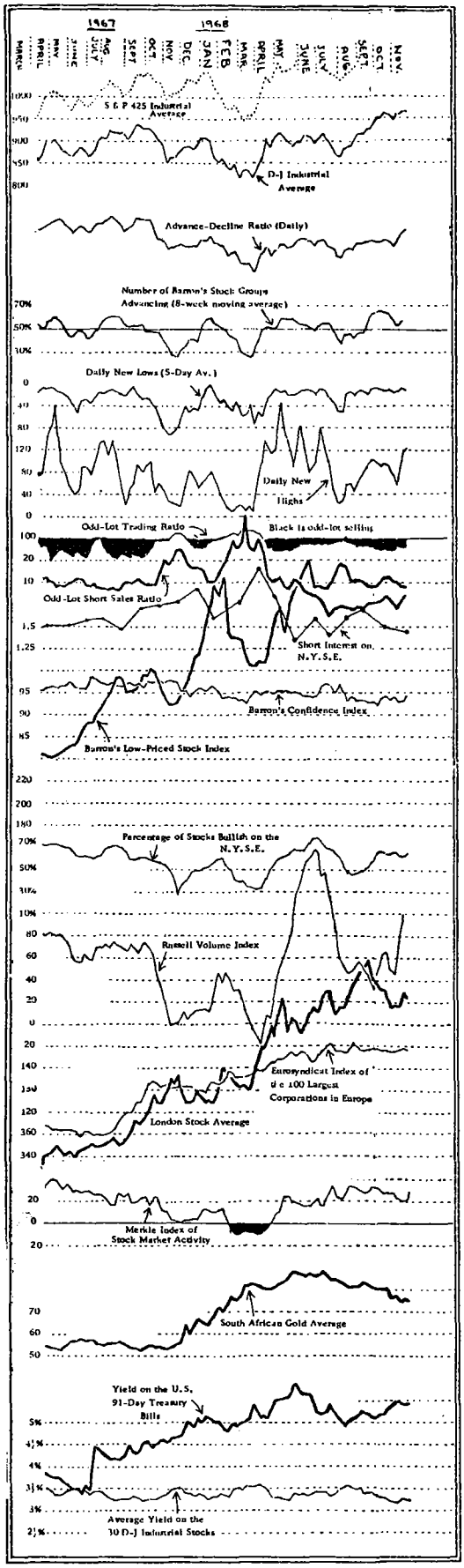
TIMING: Crises have a habit of arriving at the most inconvenient times. That, in fact, is why they are crises rather than inconveniences. The recent thinking regarding the monetary situation was that if there were to be any crisis, any devaluations, any boost in the price of gold, why wouldn't it be "natural" to occur during the new U.S. Administration? After all, the Johnson Administration had bumbled along all this time, continuing to squeak through without raising the price of gold. Why shouldn't LBJ get out free, so to speak? And well, he may. But the crisis rule says, "Don't count on it!"

The salient fact about Mr. Nixon's stable of economic advisors is that they tend to be hard money men. Men like Stans, Burns, Greenspan are a mile away in their thinking from the Johnson New Economics advocates. The Nixon men are thinking in terms of little or no inflation, and a balanced budget. And most significant of all, they have come out with no categorical statements about the price of gold. I have even thought that Mr. Nixon may have secretly warned his potential cabinet members not to make any binding statements on gold.

It is almost certain that early in 1969 Mr. Nixon will have to meet with economic leaders the Free World over in an attempt to set the monetary situation on some sort of an even keel. It is almost certain that Nixon knows the fundamental necessity of confronting the speculation in gold. The only fundamental way of confronting that speculation is to meet it head-on. My guess is that this will result in a multi-lateral agreement on a rise in the price of gold.

Now, here is the catch. What I believe, probably a great many people also believe. These people are well aware that one of the first acts of the Nixon Administration will be to confront the gold problem and very likely agree to a rise in the price of gold. This means speculation in gold in anticipation of such an event. It is this very speculation (which is probably now beginning to take place) which could precipitate the next world monetary crisis.




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Odd-Lot Short Sales Ratio
Short Interest on N.Y.S.E.
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of Stocks Bullish on the N.Y.S.E.
Russell Volume Index
Eurosyndicat Index of the 100 Largest Corporations in Europe
London Stock Average
Merkle Index of Stock Market Activity
South African Gold Average
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

 Therefore, I am skeptical of the monetary stew simmering nicely until February, whereupon Mr. Nixon will politely take over and comfortably confront the gold-monetary mess. I feel that there is a very real chance that it will be our old friend Mr. Johnson who will be faced with the crisis. And that is why it could be a crisis rather than a mere problem. Mr. Johnson does not want the problem, he does not want to be the President who devalued the dollar, he is not prepared to move. And so it may be the old story of the events not waiting for the man. (See section on Money, Gold, Crisis).

THE MARKET: The Dow Jones Industrials and Rails have been working back and forth in a fairly narrow area for almost two months, Industrials in the 950-970 area, Rails in the 265-275 area. Volume during the period has been unusually heavy.

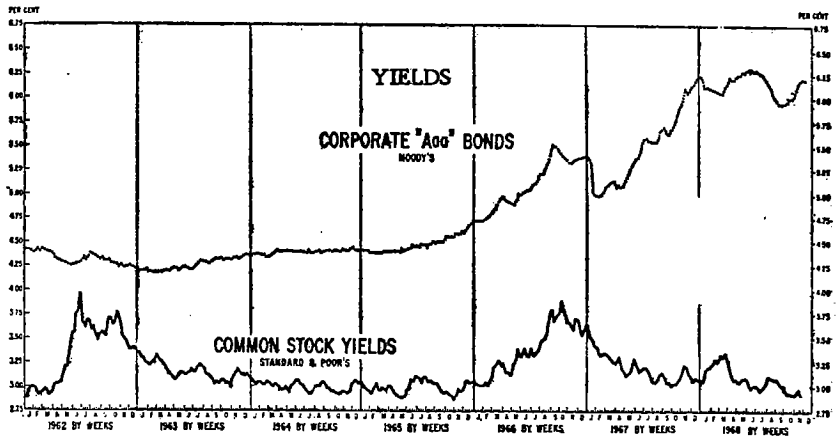
Meanwhile, the 20-day moving average of the advance-decline ratio (see last Letter) has been in the low 200 area, indicating a rather heavily over-bought market. There have been many days of divergence in the Averages (days in which one Average rallies while the other declines). Such action usually denotes uncertainty, and divergence often marks areas of distribution.

The pressure of money and interest rates undoubtedly weigh heavy on the stock market. Last week the D-J municipal bond yields climbed to 4.68%, less than 10 points from the historic record. The average yield on the broad D-J 40 Bond Average jumped to 6.68%, an incredible 3.43% more than the average yield on the Dow. With bond yields headed still higher, the pressure on stock is steadily mounting (see later section).

It has been two years and nine months since the old bull market high of 995.15 on the Dow. Dozens of devaluations of major and minor currencies have occurred since then. All indications point to a series of currency wars from here on, and one of the ways currency wars are fought is with interest rates. Informed investors must take note of this phenomenon, and from here on I would expect a highly erratic and nervous stock market.

I cannot emphasize enough the need for caution at this time. This market is being held up by expectations of more inflation, more price and wage increases, and the thesis that watered stocks are better values than watered money. History has not always held such thinking to be valid, as I believe development over the next few months will bear out.

FUNDAMENTALS: Charles H. Dow considered values to be the cornerstone of the Dow Theory. "To know values," stated Dow, "is to know the meaning of the marketplace." More specifically, Dow believed that the ultimate test of value was the return or yield on one's investment. Ultimately, all stocks must render some return to the buyer. Growth stock, glamor stock or blue-chip, there must eventually be a pay-off rather than a promise, and this is why Dow placed such emphasis on yield. As a general rule of yield, Dow wrote the following: "When a stock sells at a price which returns only about 3.5% on the investment, it is obviously dear, except there be some special reason for the established price. In the long run, the prices of stocks adjust themselves to the return on investment, and while this is not a safe guide at all times, it is a guide that should never be laid aside or overlooked."



Many of today's gunslingers and financial hipsters may snicker at such old fashioned thinking. But the facts are incredibly in Dow's favor. For despite the current reason for low yields (inflation protection), the fact is that yields have provided a rather accurate gauge of overvaluation during the past half century (or ever since Dow placed his yield observations on paper).

The "rule" which I use now applies to the broadest stock index, the Standard & Poor 500 Stock Average. Since 1958 this index has dropped below an average yield of 3% on a number of occasions. Each time this has happened the market has been vulnerable to a correction. My studies show that the average time elapsed between the 500 dropping under the 3% yield zone and ultimate trouble has been six weeks.

Last week the S & P 500 dropped to an average yield of 2.92%, equaling the low yield record for 1968. Also worth noting is that this represented the ninth week the S & P 500 has been below an average 3% yield. Thus, the yield study is now shouting "danger".

The yield picture is also evidencing trouble from another standpoint. Last week saw Moody's Aaa rated corporate bond yields (on average) rise to 6.15%. This meant (see chart page 2) that the spread between the Aaa bond yields and the S & P 500 yields was 3.23% in favor of bonds. This is an extraordinary adverse yield gap, a gap which is only 10 basis points short of the record spread of 3.33 set last July.

I might also add that the current 2.92% average yield on the S & P 500 Average is the lowest in three years. From the standpoint of straight stock yields or from the standpoint of the bond-stock yield spread this market is skating on thin ice. Every day of rally in the stock market and every day of decline in the bond market heightens the danger. It is a time for historical perspective— and caution.

PRIMARY TREND: Impatience and greed have probably been responsible for more losses in the stock market than any other human tendencies. Actually, these two character defects work together in that impatience makes men greedy and greed makes men impatient.

It may help subscribers if I review one fundamental Dow Theory observation, and that has to do with timing. Every bull market in recorded history was followed by some sort of correction or bear market. As Robert Rhea, the great Dow Theorist of the 1930's observed, there is a relationship between a bull market and the bear market which follows. As a rule, the greater the bull market the greater the ensuing bear market correction.

A simple study shows that most bear markets have wiped out one-half or more of the gains recorded by the preceding bull market. Most bear markets have also tended to last around one-third to one-half as long as the preceding bull market.

Few investors stop to consider whether the market action and timing since the February, 1966 high of 995.15 (Dow Industrials) has served to correct the excesses of the massive rise which began on June 13, 1949 (at 161.60 on the Dow). First, it is well to remember that there has been only one previous bull market in American history which can be compared with the 1949-1966 affair, and that was the bull market of 1921-1929. The aftermath of 1921-29 was a three-year bear market of fantastic severity. By 1932, 89% of the 1921-29 gains in the Dow had been erased.

While no one can expect a bear market of comparable intensity today, I think it is perfectly possible (and I expect it) to witness a bear market following 1966 of say five or six years' duration which might wipe out as much as half of the 1949-1966 gains in the Dow. Such a bear market might terminate in the 1971-72 area at around 578 or less on the Dow.

The point I want to stress is that so far since 1966 we have seen only a 251 point decline lasting from February, 1966 to October, 1966. That has been the extent of the bear market decline. Since October, 1966, a huge and deceptive correction has taken the Averages within striking distance of the old bull market highs, and many analysts over the past month have declared that under "Dow Theory," a new bull market is underway. But the fact is that in both duration and extent, nothing since February, 1966, has occurred which would qualify as a full correction of the 1949-1966 bull market. In both duration and extent the eight-month, 251 point drop of 1966 failed to correct fully the seventeen year 824 (Dow) point rise of 1949-66.

Another consideration is that primary trends do not change in a week or a month. The mere fact that the Averages a month ago bettered preceding secondary highs does not signify that "a new bull market" is in progress. Much more important for primary purposes is the matter of time, phase, duration, psychology, speculative position, yield, and volume indications, and none of these have suggested that we are in the area where a new bull market can be expected. In fact, quite the contrary is true.

William Hamilton and Robert Rhea always took careful note of the previously listed primary characteristics. When, during a bear market, a reasonable amount of time had elapsed, when speculative interest and volume had dried up, when yields were once more attractive, when public psychology had turned black, that was the time they urged readers to watch for the inception of a new bull market. It was then that the pattern of the averages took on particular importance. When most of the primary bear market bottom characteristics had appeared, then the great Dow Theorists spoke of a probable major bear market bottom. It was then that they suggested careful buying in preparation for the next major bull market.

At such times the appearance of a bull signal in the Averages would be the final proof of correct buying and proof that the turn from bear to bull had been completed. But such procedure is a far cry from the uninformed, speculative, frenzied buying which has occurred during 1967 and 1968. The 1967-68 buying, has (in my opinion) been brought on by public greed, ignorance, impatience all against a backdrop of Government manipulation, a war and massive inflation.

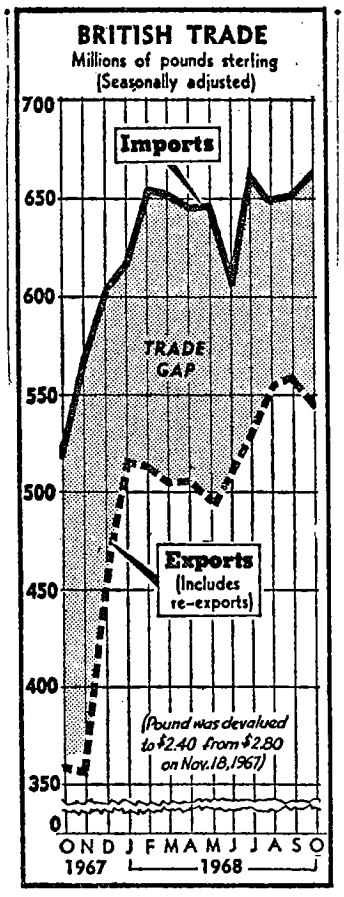
MONEY, GOLD, CRISIS: As if nature was reminding man that there is "no sure thing" in the stock market or anyplace else, we learn that the great West Driefontein gold mine was flooded out. In the ground is $1.4 billion of gold, but the estimated cost of saving the mine is $100 million. As this is written, no one is sure that the mine will or can be saved. Meanwhile, the price of the stock, understandably, has dropped drastically. It is a true Act of God and those who have sustained losses in this mine can only hope.

* * * *

On the plus side for gold share holders, there have been many worries to the effect that if devaluation occurred, the U.S. would tax the profits of gold share holders. I have never really been taken with this argument, but it was a possibility. However, I do think that the "tax the gold share holders" menace all but disappears with the election of Richard Nixon. I do not believe Nixon would accept this form of punishment for gold share holders, and to this extent I feel that the holding of gold shares becomes that much more attractive.

* * * *

Currently, as everyone knows, we are in the midst of another monetary-crisis. It appears that each new crisis is more complex and widespread than the last. The trouble became apparent when French students and workers struck some months ago. The strike was ultimately settled with huge government concessions and wage boosts averaging 13%. This action practically toppled the French economy, and the result was a massive movement out of francs. Against the franc, the German mark became embarrassingly strong, and the pressure for revaluing the mark was on. Revaluing the mark would mean putting Germany's businessmen at a disadvantage as the price of German products rose on world markets. Naturally, there is great pressure against revaluation on the part of Germans. Germans claim that one should cure the sick—instead of penalizing the healthy. And who can argue against that.



Meanwhile, the French crisis continues to boil. It has been estimated that France has half of its 1968 peak total of $6 billion in gold. The exit of capital from France has been averaging $20 to $50 million per week over the past few months. (Two weeks ago France lost $200 million in a single week). One week ago the French crisis became "official" as the French discount rate was raised from 5% to 6%. On November 19 the French government announced that it was preparing drastic economic measures to avoid devaluation and flight of currency. The 1969 French budget was to be slashed $400 million. But one can only wonder how the French students and populace will react to a new round of restrictive measures and forthcoming deflation—following their previous demand for inflation and wage boosts.

In England the pound has reacted by dropping to a ten-month low. The British trade gap (imports over exports—see chart) widened dangerously, as the trade deficit rose to $158 million in October, twice the September deficit. For the full year the trade deficit is expected to rise to $1.6 billion, highest in 17 years. Thus, the recent British devaluation has failed to "take hold," and the best that can be said is that at least the pound is not as weak as the franc. What buttons do we push next, wonder the money-manipulators of the Free World.

The two steps which were to be taken at the recent Bonn meeting were an upward re-valuation of the German mark and a devaluation of the French franc. This together with a clamping-down on the French economy was to make the franc safe for the Free World.

As the crisis of the franc flared, Frenchmen, their suitcases packed with francs, rushed to the border to convert francs to other currencies. The exchanges of Europe were closed to await the outcome. Then came the bombshell over the weekend. General de Gaulle announced that the franc would not be devalued. To the consternation of almost everyone but U.S. Secretary of the Treasury Fowler, de Gaulle stated that he would slash $1 billion off France's 1969 budget and produce the necessary measures to stop inflation head-on. In a phrase, he was going to save the franc.

A taste of what will be required even to attempt to save the franc was outlined. A freeze on food prices, public services, industrial goods. There will be higher taxes, tightened credit, and wage controls. No more "disruptive" public demonstrations will be tolerated. In a word, Frenchmen are to live amid conditions of wartime austerity. "Frenchmen, Frenchmen," whispered de Gaulle in tremulous tones, "what is happening to our money proves once again that life is a struggle, that success takes effort and that the national health demands victory." There is no question in my mind regarding de Gaulle's toughness and determination. The question, of course, is the determination of the French people.

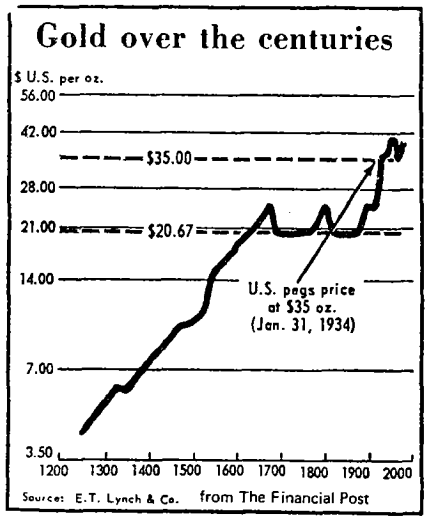
Personally, I do not think France will bring it off. Near-panic conditions were described last Monday as France placed extra guards on its borders to stop the suitcase carrying Frenchmen from converting francs. The de Gaulle announcement means that France is ready to do battle with other currencies, and the weapons will be interest rates, controls and whatever else is needed. The real battle will be between the franc and the mark. I believe France is fated to lose the battle.

The serious part of it is that if France does lose, she will then be in a much weaker position than she is now in. If that is the case, instead of a 10% to 15% devaluation such as was discussed at Bonn, the devaluation will probably have to be nearer 25% to 30%. That will surely mean tremendous pressure on the British pound and then pressure on the dollar.

In the U.S. Treasury Secretary Fowler expressed the time-honored U.S. view when he stated that he was happy that the franc was not devalued. The U.S. always goes the manipulative rather than the fundamental route. It was almost absurd to see Mr. Fowler waxing poetic, while the bankers of Europe were wringing their hands over de Gaulle's stand. I suppose we should simply sigh and say, "It was to be expected."

Conclusion: As usual, a U.S. Administration is fighting the tide. The tide is the pressure for a rise in the price of gold. By resisting this tide, the U.S. has involved itself in a maze of gimmicks, manipulations, currency exchanges and interest rate rises which are so involved and complex that there is probably not a man alive who understands their full meaning. The fundamental fact is that the price of gold has been held down artificially since 1934 while the price of everything else has risen. Yet gold forms the basis for the world's monetary system, and as world trade expands the natural pressures for a gold price rise are becoming all but irresistable.

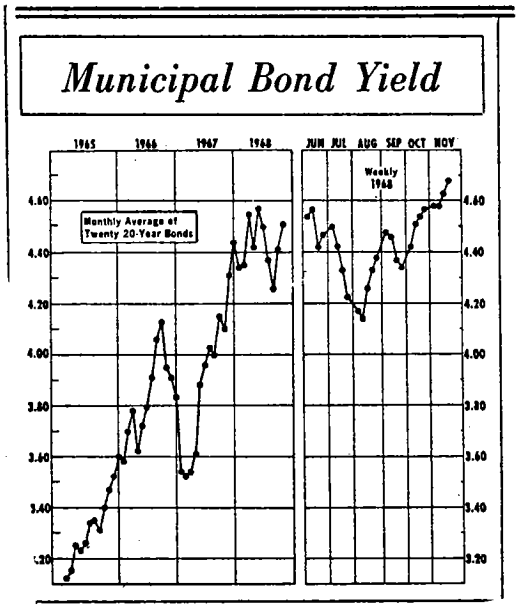
When a primary force is held back artificially, everything which goes to holding back that force becomes bent, perverted or weakened. This is exactly what has occurred throughout the world as currency after currency has collapsed in the face of a world-wide inflation of currencies against a manipulated price for gold (over 100 currency devaluations in the last seven years). The old adage states, "Gold will win." Men have attempted to disprove that adage for 5,000 years. So far, no civilization has ever "beat gold," and I submit this little chart in evidence. When the chips are down, men have always trusted the safety of gold over the good intentions of politicians.



Perhaps the best word on the whole subject comes from Eliot Janeway's latest report from which I quote: "1969's first market confrontation will be between lower foreign selling prices and higher U.S. money prices. The outcome bodes ill for American profit margins, trade results and money flows. For devaluation— we repeat, with all the emphasis at our command, not just within France but spread through all the major industrial exporting countries— is well on the way to driving foreign selling prices down, and not just nominally, but massively (but 20% plus). At the same time— and no worse time could be thought of— American interest rates are being driven up again."

CHART OF THE WEEK: (See top of Page 6). Here is the chart of the D-J Municipal Bond Average (tax free bonds) selling within a fraction of its all-time high record yield of 4.71%, set last May. At that time, the average yield on the Dow Industrials was 3.36%, against last week's even lower yield of 3.25%. Thus, the yield fundamentals are more out of wack now than was the case last May. With France set to defend the franc with (among other things) higher interest rates, and with possible retaliation from Britain, the yield comparisons will be progressively more interesting in coming months.

MARKET LABORATORY: It is interesting to watch two bellwethers of the health of the market, General Motors, which is the largest manufacturing outfit in the nation and Homestake Mining, the U.S.'s largest gold producer.



Actually, despite record auto sales, GM is essentially in the same area it has been over the past eight months. All through April to July GM hovered in the 84 area, it dipped temporarily below 80 during August and September, then ran up to 88 during October and November. As this is written GM has again dropped into the 84 area, thereby showing little or no progress in eight months. Note that the relative strength line on GM has dipped back to its area of last August. Thus this leading blue-chip has lagged behind the market.

Homestake bottomed out last August in the 31 area. Since then it has appreciated 33% while marching up to within 2 points of its all-time high of 41 3/8. The relative strength on HM has reversed, rising last week to its highest level since June. It seems to me that HM has been the gold leader on the N.Y.S.E. during 1968. I would guess that any move by HM above its last March high of 43 1/8 would precede a monetary crisis either in Europe or across the world.

Note the vertical run-up in HM prior to the French crisis. Any rally above 43 1/8 would suggest that the franc will not hold, and that a whopping French devaluation is coming up. HM is one of the most valuable barometers of international monetary developments in our arsenal.

Stock charts courtesy of my friends at Traders Research, 101 Cherry St., Alton, Illinois 62002